BRIEF

IN SUPPORT OF THE CROSS-PETITION FOR WRIT OF CERTIORARI TO WHICH THIS BRIEF IS ANNEXED

The foregoing Cross-Petition contains reference to the reports of the opinions below (p. 4); the grounds on which the jurisdiction of this Court is invoked (p. 3); and a concise statement of the case (pp. 4-10) as required by Rule 27. In the interest of brevity we refer to them here instead of repeating them.

SUMMARY OF ARGUMENT

The Court below erred in holding

(1) That unequal treatment of classes of fully secured creditors is not discriminatory;

(2) That the priorities of senior creditors may be destroyed by allocating to them, without compensation, 75% of their claim in subordinate securities;

(3) That it is unnecessary to determine conflicting claims as to what property is subject to each of two mortgages to which new securities are allocated;

(4) That "probable earnings" found by the Commission to be available for fixed charges may be used for capital investments;

(5) That creditors, at whose expense a secured creditor is paid, are not entitled to be subrogated to the rights of the creditor so paid in the collateral held by him;

(6) That, where junior creditors participate in a plan of reorganization of a railroad, the prior rights of senior creditors are recognized when they are given only the face amount of inferior securities equal to the face of their claims.

(7) That creditors secured by a prior lien on valuable property, can be required to take bonds secured by that property combined with worthless property, the deficits of which will consume a substantial part of the earnings of the original security;

(8) That the priority of senior creditors may be destroyed by alloting to them stock upon which, because of taxation, there is no probability that dividends can be paid;

(9) That the Interstate Commerce Commission "is not required to" receive and consider additional evidence of facts which have transpired during the four years elapsed since the evidence was closed before the Commission.

ARGUMENT

POINT I

A plan which treats one class of fully secured creditors less favorably than other fully secured or unsecured creditors is discriminatory and unlawful.

The statute, sec. 77 (e) (1) provides that the Plan must not "discriminate unfairly in favor of any class of creditors."

It is axiomatic that no creditor, however great be the security for his claim, is entitled to more than payment in full. It is a fundamental principle of the Bankruptcy Law that no fully secured creditor can be deprived of his security without satisfaction of his claim.

The claim of the Reconstruction Finance Corporation for about $12,000,000 is fully secured by collateral. The Plan awards to the R. F. C. one hundred per cent. of its claim in new First Mortgage Fixed Interest bonds. The Milwaukee & Northern First Mortgage bonds, aggregating $2,117,000, are fully secured by property having physical elements of value of over $4,200,000 earning more than the bond interest (R. 2248). The Plan allots to them 70 per cent. of the face of their claim in new First Mortgage Fixed Interest bonds and 30 per cent. in Second Mortgage Contingent Interest Series A bonds.

The General Mortgage, made in 1889, is fully secured by a first lien on about 6,000 miles of railroad, constituting the "Heart of the System," including terminals, shops for the building and repair of cars and locomotives and everything that goes to make up a complete railroad system, having physical elements of value of about $359,000,000 (R. 2215, 50; I. C. C. Bureau of Valuation Report Sheet 4). This does not include the Pieces of Lines East. It is a lien on locomotives, cars and other equipment, the equity in which is valued at about $49,000,000. This Mortgage secures $150,000,000 bonds, of which less than $139,000,000 are outstanding in the hands of the public, the balance being owned by the Company and pledged as security for the claim of the Reconstruction Finance Corporation.

For nearly fifty years the interest on the General Mortgage bonds was paid regularly until this proceeding was commenced in June, 1935. Their annual interest amounts to a little less than $6,000,000. The Report states that in 1936 the income available for interest of the General Mortgage Lines was over $8,700,000, and after deducting interest on equipment obligations, more than $7,500,000 (R. 2250); 1.16 times the interest on all the bonds, including those pledged with the R. F. C., and about 1.27 times the interest on the bonds in the hands of the public (Ex. 181, R. 723).

The record shows that during the first 3½ years of operation by the Trustees in Bankruptcy, ending December 31, 1938, the General Mortgage Lines (not including the Pieces of Lines East (R. 231), earned for interest more than $26,800,000—about $6,000,000 more than the bond interest (R. 229).

The Earnings Studies, which were made the "basis" (R. 2251) of the Commission's Report, assembled in Exhibit 181 (R. 723), show that the General Mortgage Lines earned more than 88 per cent. of the income available for fixed charges of the System and that with the exception of the Milwaukee & Northern they were the only Lines owned by the Milwaukee operated at a profit.

The earnings for 1939, 1940 and 1941 were much larger than those of the four preceding years.

There has been no finding, and there is no basis for a finding, that the General Mortgage bonds are not fully secured. Nevertheless, the Plan, which allots to other fully secured creditors 100 per cent. and 70 per cent. of their claims in New First Mortgage Fixed Interest bonds, allots to the General Mortgage bondholders only 25 per cent. of their claim in new First Mortgage bonds; 35 per cent. in Series A Second Mortgage Income bonds; 20 per cent. in Series B Second Mortgage Income bonds and 20 per cent. in Preferred Stock.

The finding of the Commission that the probable future earnings available for the payment of fixed charges of the Milwaukee System—$7,859,106—represents what the Commission estimates will be left of the earnings of the General Mortgage Lines after paying therefrom the deficits of the unprofitable lines. The Plan allots to the General Mortgage Lines $1,563,682 (less than one-fifth of that $7,859,106) as interest on new First Mortgage bonds (R. 1317).

The Circuit Court of Appeals in its opinion said that there were huge sums of interest unpaid on the General Mortgage bonds. That unpaid interest has all accumu-

lated since the property was placed in the hands of the Trustees in Bankruptcy. It remains unpaid, not because it was not earned but because the money was used for other purposes and accumulated in the hands of the Trustees in Bankruptcy who had in cash more than $35,000,000 on December 31, 1941.

The discrimination in favor of the unsecured claims of the Terre Haute bondholders (described on pp. 6 and 7) is fantastic.

We pray that the Court declare the law to be that a plan which gives to one fully secured creditor less favorable treatment than is accorded another fully secured or unsecured creditor is discriminatory and unlawful.

POINT II

The provisions of the Plan allocating to the General Mortgage Bondholders only 25% of their claim in new First Mortgage bonds and subordinating 75% of their claim, deprive them of their priority without compensation.

We have now a first lien prior to all the world, including the public interest (see *Louisville Bank* v. *Radford*, 295 U. S. 555, 601-2 citing the 5th Amendment to the Constitution), on practically all of the valuable property owned by the Debtor.

Our first lien is reduced to 25% of our claim. 75% is subordinated to the rest of the new First Mortgage bonds and to the fixed interest on the Terre Haute bonds whose claim against the bankrupt Debtor is unsecured.

This is in violation of the "full and absolute priority rule" established in *Northern Pacific Railway Co.* v. *Boyd*, 228 U. S. 482, which was reiterated and emphasized in *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, and in *Consolidated Rock Products Co.* v. *Du Bois*, 312 U. S. 510.

POINT III

A determination of what property is subject to each of the several mortgages is essential in the formulation of a plan of reorganization.

The statute, sec. 77 (e) (1), provides that the Plan must "conform to the requirements of the law of the land."

In the *Consolidated Rock Products* case (312 U. S. 510, p. 524) this Court declared that the absence of such a determination is "fatal" to a plan of reorganization.

The decisions of the Circuit Court of Appeals and of the District Court in this case are in conflict with that rule.

The "Pieces of Lines East"—seventeen separate short lines, aggregate about 575 miles. Only one of them connects with any other than the General Mortgage Lines (R. 221-2). They are operated at a profit over charges and in 1936 produced "net revenue from railroad operations" $1,456,800 (Ex. 181, R. 723), more than 70 per cent. as much as the like revenue produced by the 2860 miles of deficit "Lines West" (Ex. 181, R. 723). Either they are or they are not subject to the lien of the General Mortgage.

The Commission expressly declined to decide whether or not these "Pieces of Lines East" are subject to the General Mortgage upon the ground that it is a judicial question for determination by the Courts (R. 1151) and said in its report:

> "The propriety of crediting the First and Refunding Mortgage or the 50-Year Mortgage with the earnings of the 'Pieces of Lines East' is rendered doubtful in the absence of a judicial determination of the question whether these lines are subject to the first lien of the first and refunding mortgage or to that of the General Mortgage" (R. 2252).

The failure to make this determination was one of our objections to the Plan (R. 1424); and one of our points on appeal to the Circuit Court of Appeals (R. 2069). The question was argued both orally and by brief before both Courts and neither Court determined that question.

It was not included in the list of matters referred back to the District Court by the Circuit Court of Appeals (R. 2308-9).

If the writ be granted we shall ask this Court to decide that question of law which was not decided below.

POINT IV

Section 77 of the Bankruptcy Law does not invest in the Interstate Commerce Commission, or in the Court, the power to divert to capital expenditures any part of the probable future earnings which the Commission shall find to be available for the payment of fixed charges.

Section 77(b) (4) directs that the Commission

> "Shall provide for fixed charges (including interest on funded debt, interest on unfunded debt, amortization of discount on funded debt and rent for leased railroads) in such an amount that * * * there shall be adequate coverage of such fixed charges by the probable earnings available for the payment thereof; * * *."

The Commission has found the probable earnings available for the payment of fixed charges ("the average for the five years—1931-5—considered to be a minimum" [R. 2219]) to be $7,859,106 and that a coverage of 116% is adequate, leaving $6,769,654 applicable to the payment of fixed charges as provided by the Statute (R. 2219 and 2190).

Its Report (R. 2219) recites that the Committee of the Group of Institutional Investors had proposed that the probable earnings available after deducting adequate coverage be applied to the payment of fixed charges and that an Additions & Betterments Fund be provided, *not* out of probable minimum net earnings available for fixed charges but out of the estimated earnings for the future normal year.

The Commission did not find that such a plan would be unsound, but it said:

> "* * * a *sounder course* would be to *include the obligatory payment* for the (Additions and Betterments) fund *with the proposed fixed interest charges* keeping the total within the coverage of the past average earnings determined as before. If the fixed interest charges be limited to about $4,269,654 and the mandatory payment to the fund to $2,500,000 a year, the total, $6,769,654, would be covered about 1.16 times by the average earnings for the period 1931 to 1935 and 1.18 times for the period 1932 to 1936 * * *. We conclude that the limitation of *fixed charges* of the System at approximately $4,269,654 a year is reasonable and proper. We find that there will be adequate coverage of such amount of fixed charges of the new company by the probable earnings available for the payment thereof" (R. 2219). (Italics ours.)

Instead of complying with the law and applying to the payment of *fixed charges* the "probable earnings available," the Commission has provided that $2,500,000 of these earnings shall be used for *capital expenditures,* which should be paid from capital funds or surplus earnings. This provision is not only unfair and inequitable, but we insist that it is unlawful, and beyond the powers granted by the statute.

This provision reduces by $62,500,000 the new First Mortgage Fixed Interest bonds upon which the "probable earnings available" would pay the fixed charges. Practically all of those bonds would be distributable to General Mortgage bondholders. During the fifty year life of the

new bonds, $125,000,000, which should be paid in interest, would be diverted to capital investments for the benefit of junior classes of creditors who will receive stock for their claims.

This is a proceeding under a statute which is in derogation of the common law. It must be strictly construed. It provides that the probable earnings available for the payment of fixed charges shall be used for the payment of fixed charges. The statute grants no power to use them for any other purpose.

The need for a strict construction of the grant of power is emphasized by the fact that we have here the anomalous position of the body which fixes the rates upon which railroad earnings depend, also clothed with authority to cut down the railroads' capitalization to fit the rates which it had previously made—wiping out in this instance hundreds of millions and in the aggregate of all reorganized railroads, billions of actual invested capital. Having done that they may again reduce the rates to fit the new capitalization and so *ad infinitum,* or rather *ad infinitessimum.*

This is the vicious circle condemned by Mr. Justice Brandeis in *Southwestern Telephone Co.* v. *Public Service Commission,* 262 U. S. 276, p. 292.

POINT V

Creditors at whose expense another secured creditor is paid are entitled to be subrogated to the rights of the latter in the collateral which was held as security for his claim.

The claim of the Reconstruction Finance Corporation of about $12,000,000 is secured by $11,212,000 Series G General Mortgage Bonds, by the 1st and Refunding Mortgage Bonds and by other collateral, including the Terre Haute stock.

The Plan provides that instead of permitting the Reconstruction Finance Corporation to realize on its col-

lateral, the loan shall be paid 100% in New First Mortgage bonds.

This reduces by about $12,000,000 the First Mortgage bonds which would be distributable to General and Milwaukee & Northern bondholders.

For all practical purposes the loan is being paid by the Generals and Northerns. In fairness and equity they should be subrogated to the rights of the Reconstruction Finance Corporation.

> "* * * the equitable doctrine of subrogation * * * has been steadily growing in importance and widening its sphere of application. It is a creation of equity and is administered in the furtherance of justice. It is applied to give the party who pays the debt the full benefit and advantage of such payment."
>
> *Rachal* v. *Smith,* 101 Fed. 159 (C. C. A. 5th).

> "The doctrine of subrogation is one of equity and not of the common law and, in its application, no attention should be paid to technicalities which are not of an insuperable character, but broad equities should always be sought out as far as possible."
>
> *Merchants & M. Transport Co.* v. *Robinson & Co.,* 191 Fed. 769-772 (C. C. A. 1st).

> "These Federal cases clearly reflect the rule requiring liberal application of the doctrine of subrogation, and we think they have so far committed the Federal Courts to that rule that we ought not to refuse to follow the path they have chosen."
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> *Burgoon* v. *Lavezzo,* 92 Fed. 2nd 726-36 (Ct. of Appeals, D. C. '37).

The Series G General Bonds and the 1st & Refunding Bonds held by the Reconstruction Finance Corporation are to be cancelled under the Plan.

Under the Plan, the allocation of securities to the 50-Year Mortgage is based on the fact that that mortgage is now a second lien on the security on which the 1st & Re-

funding Mortgage is now a first lien. It makes that security and the claim that the 50-Year Mortgage will then be a first lien on the "Pieces of Lines East" the basis of allotting to the 50-Year Mortgage about $19,000,000 of Class B Contingent Interest bonds, on a parity with 20% of the General Mortgage bondholders' claim, and gives them priority over the 20% Preferred Stock allotted to the Generals.

These allotments absolutely ignore the fact that this loan is to be paid, the 1st & Refunding Bonds cancelled, and these assets freed at the expense of the General Mortgage bondholders, and ignores their right to subrogation to the rights of the Reconstruction Finance Corporation.

POINT VI

The Plan in which junior interests participate does not "afford due recognition" to the prior rights of the General Mortgage Bondholders by giving them "only the face amount of inferior securities equal to the face amount of their claims."

In the *Consolidated Rock Products* case (312 U. S. 510, pp. 528-9) this Court declared that to be the law where *stockholders* participate, and declared that "They (bondholders) must receive, in addition, compensation for the senior rights which they are to surrender" (312 U. S. 510, p. 529).

The same opinion stated that "Unless meticulous regard for earning capacity be had, indefensible participation of *junior securities* in plans of reorganization may result" (312 U. S. 510, pp. 525-6). (Italics ours.)

So we feel justified in asserting that this Court intended the rule to apply as between senior and junior creditors.

Nevertheless the Commission expressly refused to give the General Mortgage bondholders any additional compensation for their senior rights (R. 2255).

POINT VII

The inclusion of the deficit lines in the new First Mortgage unlawfully deprives the General Mortgage Bondholders of their security, their priority and their property.

The General Mortgage Lines upon which we have a prior lien have a value far beyond the amount of our mortgage. They constitute a complete railway system which has always operated at a profit over its bond interest.

The bankruptcy of the Milwaukee has resulted from taking General Mortgage earnings to pay operating deficits of the "Lines West", and interest on the 50 Year 5% bonds.

The Commission has found that those lines cannot be expected to earn anything for the payment of interest.

As this Court has established the law that earning capacity is the sole criterion of value—no commercial value can be attributed to them. The only possible justification for their continued operation is to render service to the public. But, if the public interest require their continued operation it should be done at public expense.

The reason that the Commission's estimate of probable future earnings is so small is because the operating deficits of the "Lines West" must first be deducted from the earnings of the General Mortgage Lines, and the Plan proposes to saddle upon those earnings, not only the operating deficits but also the cost of additions and betterments to the "Lines West".

In order to accomplish this public benefaction, our priority and our lien are destroyed; we receive only twenty-five per cent. in new First Mortgage bonds, the security for which is less valuable than our present security; seventy-five per cent. of our claim is subordinated to the other first mortgage bonds to be issued and to the principal of and fixed interest on the Terre Haute bonds,

and for that 75% of our claim we are offered progressively inferior engravings which cannot be dignified with the name "securities".

This does not "afford due recognition to our rights"; it does not "conform to the requirements of the law of the land," as established by the Fifth Amendment to the Constitution and the decisions of this Court in *Louisville Bank* v. *Radford,* 295 U. S. 555, pp. 601-2 and *Consolidated Rock Products Co.* v. *Du Bois,* 312 U. S. 510.

POINT VIII

The provisions for the issuance to the General Mortgage Bondholders of 20% of their claim in preferred stock is, by reason of the Tax Laws, confiscation.

Having limited the fixed interest debt to about $109,000,000 the Commission stated no reason for limiting the contingent interest debt to $115,000,000 and issuing about $323,000,000 of stock to represent about 60 per cent. of the new capitalization (R. 1317).

With the bonded indebtedness reduced to about 40% of the total new capitalization, the Additions and Betterments Fund and Sinking Fund payments would be subject to income taxes and everything above $9,500,000 fixed and contingent interest would be subject to both income and excess profits taxes.

The Revenue Act of 1941 is now the law of the land of which this Court will take judicial notice. The rates of taxation are no longer a matter of estimate or guesswork.

Under the present tax law, $20,000,000 income would not be sufficient to pay all of the contingent interest. It will require about $44,000,000 earnings (more than ten times the fixed charges established by the Plan) to pay the Preferred Stock dividends and the earnings would have to reach astronomical figures to pay the $3.50 dividends

contemplated by the Plan (R. 2242) on the $215,000,000 common stock. The Milwaukee never earned as much as $33,000,000.

The S. E. C. sends people to prison for issuing worthless securities.

The avowed purpose of reducing the bonded indebtedness to such a low figure is to make sure that the reorganized company can carry on in periods of possible low earnings. Income bonds, contingent on earnings, with voting rights would be just as effective for that purpose and if the Company continue to prosper those who loaned their money would get returns on their investment. It is not "compatible with the public interest" to so arrange the new capitalization that those returns will go instead to the Government in taxes, because it is unfair, inequitable and confiscatory. Confiscation is never "compatible with the public interest," except as a penalty for wrongdoing.

POINT IX

The decision of the Circuit Court of Appeals should be modified by directing the Interstate Commerce Commission to consider the evidence received before the District Court and to receive and consider other relevant evidence as a basis for its findings.

The judgment upon each appeal directs the District Court "To remand the case to the Interstate Commerce Commission for the making of findings, and, *if necessary*, the taking of additional evidence that additional findings may be made *as indicated in the opinion of this Court filed herein*" (R. 2318-24). (Italics ours.) That opinion is thus a part of the judgment and is a mandate to the Interstate Commerce Commission as to the rules which shall govern its action.

If some parts of that mandate be erroneous they should be reviewed by this Court in order that the law

applicable to this and other similar proceedings may be finally established and the judgment modified accordingly.

On an application to modify the opinion, the Court said: "In other words, the *Interstate Commerce Commission has jurisdiction of the matter and may, although it is not required to do so, re-examine the evidence, or receive additional evidence, if, in its judgment, justice to the parties requires it*" (R. 2335). (Italics ours.)

1937 was the last full year's earnings available when the evidence before the Commission was closed in March, 1938. Since that time the earnings of the Debtor, and of other railroads, have multiplied. In 1939, the Milwaukee earned nearly $10,000,000 available for fixed charges; in 1940, it earned nearly $15,000,000 and in 1941, it earned nearly $30,000,000. These increased earnings are the result not only of increased gross revenues but of efficient and economical operation, reduced costs, reduced interest rates on equipment trust certificates, reduction in the outstanding debt, the introduction of Diesel locomotives and many other factors, some of which were proved before the District Court.

The evidence before the Interstate Commerce Commission showed that the Milwaukee and Northern Consolidated Mortgage Lines had, prior to 1937, more than earned the interest on the bonds, and the Plan treats those bonds on that basis. Before the District Court it was proved that by reason of an "Ore Pooling Agreement", approved by the Interstate Commerce Commission, they had become permanently deficit lines. Their deficit in 1939 exceeded $500,000 (R. 1723, 1746-8).

Section 77(e) provides that "The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power, past, present and prospective, and all other relevant facts." The earnings of 1939-41 are now past earnings.

Atcheson, Topeka & Santa Fe Railroad v. *United States,* 284 U. S. 248, was a suit in equity to nullify an

order of the Interstate Commerce Commission in a rate case under the Interstate Commerce Commission Act. The Commission had taken testimony down to 1928 and made an order in 1931 fixing rates based upon the conditions existing during and prior to 1928. This Court held that it would take judicial notice of the fact that economic conditions affecting railroads had changed and that while such an order might have been proper at the time when the testimony was closed, changes in economic conditions made it no longer fair.

The same rule should apply here where the evidence before the Commission was closed four years ago and an even greater change in railroad earnings has occured during those four years than occurred between 1928 and 1931.

In empowering the Interstate Commerce Commission to estimate the probable future earnings available for the payment of fixed charges, and to make that estimate the basis of its plan of reorganization, the Congress did not, and did not intend to, endow the Commission with prophetic omniscience. This contention is supported by the provision of the Statute authorizing the District Court to receive additional evidence (§ 77 (e)).

That bondsholders who have invested hundreds of millions of dollars in the mortgage bonds of this Railroad should be deprived of their property without compensaiton because the Commission made a bad guess in 1940, based upon conditions which existed before 1938, would be a travesty of justice.

New York, March 20, 1942.

Respectfully submitted,

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